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Personnel and Labor Relations Study Commission

STAFF REPORT NO. 18
PERFORMANCE APPRAISAL AND
ITS RELATIONSHIP TO MERIT PAY

Objective: To provide information for the Personnel and Labor
Relations Study Commission Study Question 19:

"Should all state agencies be required to
impliment a performance appraisal system?" and
on performance appraisal requirements for merit pay.

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Introduction

This paper presents a brief overview of the appraisal of employee performance and its relationship to performance based pay systems.

PRINCIPALS OF PERFORMANCE APPRAISAL:

Performance Appraisal is being recognized as a more and more important tool in the management of organizations. One author has stated the importance of performance appraisal as:

"Performance appraisal is a vital process for effective management. Feedback on performance benefits both the individual and the organization. The individual who identifies with his job is anxious to get constructive feedback on his performance. The organization, in turn, constantly requires assessment as to the effectiveness of its structures and processes. Performance appraisal serves both the individual's and the organization's needs."¹

This increased emphasis, however, has also increased the awareness of how difficult the appraisal of performance can be and how inadequate traditional appraisal techniques have been in meeting their objectives.

Practitioners and authors concerned with performance appraisal almost universally agree that the traditional rating scales which emphasize personal traits are ineffective. They are seen as more form than substance, may decrease motivation and communicate very little of value either to the supervisor or to the employee. A recent text on employee productivity and motivation concludes:

"The evidence currently available indicates that systems utilizing supervisor ratings of personal traits and focusing on nonspecific aspects of performance are not valid or effective enough to be worthwhile. Governments using such rating systems have failed to meet the burden of proof in court cases in which the validity of their systems has been challenged. Performance appraisal and its connection with pay and promotion are also under attack by unions in some jurisdictions. Yet despite these pressures and questionable validity of rating instruments and procedures, many governments continue to use such supervisor ratings to justify personnel actions."²

Traditional appraisals have not fared well in the courts either. A recent study of the factors which contributed to success in defending against discrimination suits found:

"Courts have not been receptive to trait-oriented appraisals because there is too much potential for subjectivity and bias; instead, they seem to expect and require specific, objective criteria or behavior-oriented appraisals."³

The authors analyzed 66 court cases involving alleged discrimination caused by the use of performance appraisals. They identified several

factors which significantly contributed to the employer's success in defending the appraisal practices:

Factors Associated with the Courts' Decisions⁴

Factor	<u>Number of Cases Found for:</u>	
	Plaintiff	Defendant
Was job analysis used to develop the appraisal system?		
Yes	0	3
No	11	3
What type of appraisal system was in use?		
Behavior-oriented	7	16
Trait-oriented	17	8
Were evaluators given specific written instructions?		
Yes	1	11
No	14	1
Were appraisal results reviewed with employees?		
Yes	2	7
No	3	0

The authors conclude:

"On the basis of our analysis we've made the following recommendations that may help employers successfully defend themselves if a discrimination charge or suit is brought against them: First, employers should attempt to reduce the possibility that an employee will be able to establish a prima facie case of discrimination (if, for example, there is a disproportionately small percentage of females and minorities in managerial and higher-skilled positions) by setting up affirmative action programs. Second, the employer must be certain that the content of the performance appraisal system is based on job analysis and that performance measures are job-related, specific work behaviors and not based on general traits that lend themselves to opinion, subjective judgment, and rater bias. Third, in administering the program, detailed, clearly written instructions should be given to each appraiser/supervisor. Finally, the appraisers should be required to discuss the rating results with each employee to ensure that these appraisal sessions are productive and contribute to employee effectiveness. Each supervisor should be trained in how to rate employee performance and how to provide feedback."⁵

The dissatisfaction with the effectiveness and defensibility of traditional rating scales has led to significant changes in the nature of performance appraisal systems. The following chart shows a number of recent trends in performance appraisal systems:

Trends in Performance Appraisal¹⁶

<u>Aspect of Process</u>	<u>Former Emphasis</u>	<u>Present Emphasis</u>	<u>Reason for Change</u>
Basic Objective	Merit rating -data for a variety of personnel decisions	Individual development and improved productivity	Different employee attitudes, research findings on productivity, flaws in rating process
Use of Data	Basis for retention, wage increase, promotion, transfer, lay-off	Day-to-day communication between supervisor and employee feedback on performance	As above plus legal standards for "employment decisions"
Techniques	Numerical rating scales and statistical manipulation of "scores" for comparison purposes	Mutual goal setting, specific performance standards, group appraisal, critical incidents, non-numerical feedback	Inaccuracy of numerical ratings, failure of ratings in performance improvement
Application	For hourly paid workers	For technical, professional and managerial employees	Increased need for productivity assessment and improvements at these levels
Factors Rated	Personal traits and personality factors, products which can be counted	Observable behaviors in work process, results, accomplishments	Lack of accuracy and job-relatedness of trait evaluation, increased need for work planning
Interaction of Supervisor and Employee	Supervisor periodically tells employee of rating, might "sell" or "impose" rating, seeks conformance on work expectations	Supervisor stimulates employee to analyze own objectives, "coaches" and counsels on daily basis	Research findings on productivity, trend toward participatory management

MONTANA PERFORMANCE APPRAISAL SYSTEM:

State law requires that state personnel policies be implemented for "improvement of employee effectiveness" and the "evaluation of productivity" of permanent employees (2-18-102, MCA). In addition, the 46th legislature (1979) through a joint resolution, directed the Department of Administration to develop a performance appraisal system and to implement a uniform system of performance-based evaluation through periodic supervisor/employee conferences. The Personnel Division developed an appraisal system and adopted a performance appraisal policy as state rule in December, 1980. The rule requires agencies to adopt a performance appraisal system which meets certain

minimum standards set forth in the rule.

The model system and policy adopted by the Personnel Division were developed with careful attention to the legal considerations and trends in performance appraisal. Features were borrowed from systems which have proven effective in other organizations and features were avoided that have proven to be ineffective or legally indefensible.

Implementation of performance appraisal in state government is still in its early stages. The Personnel Division has offered supervisory training to the management of agencies upon request. The model system is being adopted in several agencies and others are adopting variations of the system that meet the minimum standards in the state policy. A number of agencies have yet to begin the implementation of a performance appraisal system. It is too early to evaluate the degree or success of implementation. Most practitioners believe that it takes up to three years to completely implement a performance appraisal system.

RELATIONSHIP OF PERFORMANCE APPRAISAL TO MERIT PAY AND OTHER INCENTIVES:

The performance appraisal system is the basic measurement/judgment process supporting any system which rewards or recognizes employees for performance. It is the most important and the most difficult part of any incentive plan or pay-for-performance system. A merit pay mechanism is a procedural process which is usually quite easy to design and administer. It is easy to set up a bonus plan, deciding who gets the bonus is the tough part.

No one has found a perfect way to measure performance and a number of organizations have had performance appraisal systems fail. The likelihood an appraisal system will be unsuccessful is increased when the appraisal results are directly tied to rewards.

Modern performance appraisal systems have some requirements and objectives which compete with the requirements of a merit pay system. Modern appraisal systems are designed with the basic objective of motivating employees to improve performance by improving employee/supervisor communications. They are concerned with employee counseling and development more than with evaluation. Many new systems discourage comparison between employees or the quantification of performance measures.

Most authorities on performance appraisal agree that if appraisal results are too closely tied to pay increases the motivational benefits of improved communication can be lost. As one author states:

1. Performance appraisal should be developmental rather than evaluative and punitive. A performer should learn of his efficiencies and deficiencies. The latter should be accompanied by plans for improvement, thus giving a future orientation to the system.
2. Performance appraisal should be separated from promotion and other reward allocations. The performance appraisal and feedback should be a developmental process focussing on how a person can improve. Such a process requires both parties to be open and free in exchanging ideas. Promotion and other reward allocation tend to be more evaluative processes in which both parties are more defensive. There is no easy resolution of the problem that

promotion and merit awards will be made on the basis of data collected for performance appraisal and consequently, what should be a developmental process may be a sham evaluative one.⁷

A major study of the effects on performance of various appraisal techniques was done by the General Electric Company in the 1960's. They found that participative processes such as mutual goal setting which increased supervisor/employee communications had the most positive effect on performance. They found, however, that the improvements in performance were often lost if salary increases were discussed as part of the appraisal meeting. They concluded:

"Interviews designed primarily to improve a person's performance should not at the same time weigh salary or promotion in the balance."⁸

Interviews or decisions about salary or other personnel actions, even though they may use information from the appraisal process, should be conducted at a separate time.

Greener, et al. in their book on productivity and motivation state:

"If the appraisal is not based on observable or measurable performance and clear criteria agreed on beforehand by supervisor and employee, there is a good possibility that supervisor and employee will disagree in their assessment of the employee's performance.

If employees stand to lose pay, promotion, or job security, they may be less likely to engage in frank mutual discussion of their weaknesses. Such reticence can prevent the identification of training and development needs. There is evidence that such reticence does indeed occur when appraisals are linked to personnel actions."⁹

These authors also found that supervisors do a better job of appraising performance if the ratings are not directly tied to salary or promotion.

"Ratings by the immediate supervisor have been found to be more valid than ratings by persons who do not observe much of the day-to-day work of the employee. However, there is evidence that the validity of an immediate supervisor's rating is diminished in situations where important decisions (such as promotion and salary) depend on the rating."¹⁰

The objective of merit pay programs is to increase productivity by rewarding superior performance. Logically, incentive pay systems work best when superior performance can be clearly identified and incentives can be closely connected to the superior performance. There is considerable evidence that incentive systems work best where there is a clear connection between pay increases and job results.

Merit pay programs therefore require well-established, job-related performance appraisal systems and that judgments concerning relative performance have to be as fair and job-related as possible.

From a pure compensation perspective, practitioners would like to see merit pay tied as directly to the measurement of performance as possible. There are obviously some competing requirements between merit pay programs and performance appraisal programs. Merit pay works best at improving productivity when it is as directly connected to performance results as possible and performance appraisal motivates best when it is not used to directly decide pay issues.

POSSIBLE APPROACHES:

Organizations have found that the two processes are compatible for jobs where results can be easily and precisely measured; for example, where results can be counted or timed. In these cases, merit pay can be tied directly to a measure of results and there is much less likelihood that the employee and supervisor will disagree about the level of performance. In these types of jobs, incentive pay systems have worked well in improving both the productivity and the satisfaction of workers.

In other types of jobs where precise measurement of performance is more difficult, the two processes are not as compatible. Private companies often solve this problem by making individual pay decisions based on a wide variety of factors at a time other than the performance appraisal interview. Although it is understood that one's performance level can affect salary increases, the salary interview is seen as a separate decision process which considers a number of factors.

Other organizations have set up an intermediate process or even two separate evaluation processes. This avoids a direct connection between the two systems while still providing a direct evaluation for pay purposes. One system is usually designed to improve performance and employee/supervisory communication. The other system makes an overall evaluation of the employee's contribution for pay purposes only. The two evaluations are made at separate times although information from the first may be used to support decisions on the second.

The United States Office of Personnel Management recommends such a dual approach. They recommend that once an employee's performance has been appraised using a job-related appraisal system with mutually established performance standards, the supervisor should give an overall evaluation which would determine the size of a merit pay increase. The U.S. Office of Personnel Management recommends an overall rating based upon the following five levels.

1. Far Exceeds Requirements. Overall performance in which the employee consistently performs in an exceptional manner with respect to established performance standards. The employee must have demonstrated some "Far Exceeds" levels of performance in individual critical elements of the position and no performance element may be less than "Exceeds Requirements."
2. Exceeds Requirements. Overall performance in which the employee consistently performs in a manner which exceeds established performance standards. In the individual element ratings, all critical elements on the position must be rated "Exceeds Standards" or higher and noncritical elements must be rated "Satisfies" or higher.
3. Meets All Requirements. Overall performance in which the employee consistently performs in a manner which meets

established performance standards. In the individual element ratings, all elements must be rated "Satisfies" or higher.

4. Meets Minimum Requirements. Overall performance which is acceptable. In the individual element ratings, all critical elements must be rated "Satisfies" or higher. Some noncritical elements are rated "Does Not Satisfy."
5. Fails Requirements. Overall performance deemed to be unacceptable; i.e., performance which does not satisfy established performance standards in one or more critical elements of the employee's position."11.

This method would divide employees into five groups to determine the amount of bonus, pay increase or other incentives that would be received.

RECOMMENDATIONS:

1. All state agencies should be required to adopt a job related performance appraisal system which complies with the minimum standards in the state's performance appraisal policy.
2. Agency management should be committed to the successful implementation of performance appraisal as a motivational tool and every supervisor should be adequately trained in the purposes and procedures of the agency's appraisal system.
3. No agency should adopt a merit pay program for any of its employees until there is a job-related performance appraisal system completely implemented. The system should be fully operational as a communication and development tool before a merit pay program is undertaken.
4. Any proposal to use performance appraisal as a support for a merit pay program should be very carefully developed with full consideration of the competing requirements and possible approaches outlined in this paper.
5. Every effort should be taken to maintain performance appraisal as a participatory communications tool and not simply a ranking device to directly support or decide important personnel decisions. If merit pay systems are established they should include an intermediate evaluation process like that recommended by the U.S. Office of Personnel Management.

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